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I returned a few days ago from Kuala Lumpur, the capital of Malaysia, where the talk of the town – well, at least among economists -- is the “middle-income trap.” What's that, you ask? A developing nation gets “trapped” when it reaches a certain, relatively comfortable level of income but can't seem to take that next big jump into the true big leagues of the world economy, with per capita wealth to match. Every go-go economy in Asia has confronted this “trap,” or is dealing with it now. Breaking out of it, however, is extremely difficult. The reason is that escaping the “trap” requires an entire overhaul of the economic growth model most often used by emerging economies.

Malaysia's caught in the “trap” right now, and getting out if is going to be tough. Simply put, Malaysia needs to change what it has been doing economically for the past 40 years. How Malaysia got itself into the “trap,” and how it could escape from it, can provide us with some valuable lessons on development and, more specifically, how developing nations can graduate into becoming fully advanced economies.

The concept behind the “middle-income trap” is quite simple: It's easier to rise from a low-income to a middle-income economy than it is to jump from a middle-income to a high-income economy. That's because when you're really poor, you can use your poverty to your advantage. Cheap wages makes a low-income economy competitive in labor-intensive manufacturing (apparel, shoes and toys, for example). Factories sprout up, creating jobs and increasing incomes. Every rapid-growth economy in Asia jumpstarted its famed gains in human welfare in this way, including Malaysia.

However, that growth model eventually runs out of steam. As incomes increase, so do costs, undermining the competitiveness of the old, low-tech manufacturing industries. Countries (like Malaysia) then move “up the value chain,” into exports of more technologically advanced products, like electronics. But even that's not enough to avoid the “trap.” To get to that next level – that high-income level – an economy needs to do more than just make stuff by throwing people and money into factories. The economy has to innovate and use labor and capital more productively. That requires an entirely different way of doing business. Instead of just assembling products designed by others, with imported technology, companies must invest more heavily in R&D on their own and employ highly educated and skilled workers to turn those investments into new products and profits. It is a very, very hard shift to achieve. Thus the “trap.”

South Korea is probably the best current example of a developing economy making the leap into the realm of the most advanced. Companies like Samsung and LG are becoming true leaders in their fields. Taiwan isn't far behind. China's policymakers are fully aware that, with labor costs rising, it needs to follow suit.

Malaysia, though, is quite far from where it wants to be. That's a bit surprising based on its remarkable recent history. Malaysia has been among the best performing economies in the world since World War II, one of only 13 to record an average growth rate of 7% over at least a 25-year period. The country has an amazing record of improving human welfare. In 1970, some 50% of Malaysians lived in absolute poverty; now less than 4% do. Yet Malaysians also feel that they've become somewhat stuck where they are. GDP growth has slowed up, from an annual average of 9.1% between 1990 and 1997 to 5.5% from 2000 and 2008. Meanwhile, other Asian economies have zipped by Malaysia. According to the World Bank, the per capita gross national income (GNI) of South Korea in 1970 was below that of Malaysia ($260 versus $380), but by 2009, South Korea's was almost three times larger than Malaysia's ($21,530 versus $6,760). Malaysia is getting “trapped” as a relatively prosperous but still middle-income nation.

Can Malaysia escape? The initial indications are not encouraging. The economy's growth engine remains unchanged – export-oriented manufacturing backed by foreign investment. Its companies are just not innovating or adding much value to what they produce. You can find all of the ugly details in a very thorough study by the World Bank, released in April. Private investment has sunk precipitously, from more than a third of GDP in the mid-1990s to only some 10% today. Labor productivity is growing more slowly than in the 1990s. The “value-added” in manufacturing in Malaysia trails many of its neighbors – an indication that Malaysian factories are mainly assembling goods designed elsewhere. R&D spending remains frighteningly low, at about 0.6% of GDP (compared to 3.5% in South Korea). If Malaysia is going to break the “trap,” it has to reverse all of these trends.

How can Malaysia achieve that? The World Bank report has pages of recommendations. The basics include slicing apart the bureaucratic red tape that stifles competition and suppresses investment, bolstering the education system so it can churn out more top-notch graduates, and funneling more financial resources to start-ups and other potentially innovative firms. To its credit, the government of Malaysia is fully aware of what it needs to do. In March, Prime Minister Najib Razak introduced a reform program called the New Economic Model. You can read the initial report here. The NEM shows that Najib realizes that excessive government interference in the economy is dampening investor sentiment and holding back Malaysian industry. All eyes now are waiting for the more detailed policy recommendations for the NEM (though it is not clear when those might appear).

Yet I'm wondering if getting policy right is really enough. Of course, it would help, by setting in place better incentives for private businessmen to invest in innovative projects, and creating the tools they need to make those projects work. But I don't think that's the whole story. I've been musing on the differences between South Korea and Malaysia. Why has Korea jumped so far ahead? I think the reason is embedded in the different methods the two countries used to spur rapid growth.

Both countries relied exports to create rapid gains in income, but they did so differently. South Korea, from its earliest days of export-led development in the mid-1960s, had been determined to create homegrown, internationally competitive industries. Though Korean firms supplied big multinationals with components or even entire products, that was never enough – Korea wanted to manufacture its own products under its own brands. The effort was often a painful one – remember Hyundai's first disastrous foray into the U.S. car market in the late 1980s and early 1990s – but Korea is where it is today because its private companies have been working on getting there for a very long time, backed in full by the financial sector and the government.

Malaysia, on the other hand, relied much, much more on foreign investment to drive industrialization. That's not a bad thing – multinational companies provide an instant shot of capital, jobs, expertise and technology into a poor country. MNCs, however, aren't going to develop Malaysian products; that has to take place in the labs and offices of Malaysia's private businesses. But those businessmen have been content to squeeze profits from serving MNCs and maintaining their original, assembly-based business models.

In other words, what is needed for Malaysia to break from the “middle-income trap” is a greater national commitment to innovate on its own. Entrepreneurs and bankers have to be willing to take more risks to support inventive ventures and new technologies. Talented workers have to be willing to take jobs at home instead of Silicon Valley. The Malaysian private sector has to be more devoted to the country's future. This is fuzzy stuff, outside of the realm of usual economics. But I fear the kind of commitment needed to escape the “trap” unfortunately can't be created by government initiatives alone.

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